

QUARTERLY REPORT



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

February 22, 2005

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2004. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,670 active members and 4,559 retirees participating in the ERS as of June 30, 2004.

Performance Results

The total return achieved by the ERS assets for the quarter was a 8.72% compared to the benchmark index return of 8.11%. For the one year period ending December 31, the ERS' gross return (before fees) was 12.46%, over 111 bpts. above the benchmark index return of 11.35%. The strong one-year return places the ERS' performance in the top 25% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. The outperformance continued through January with the one-year return 70 basis points above the benchmark index. The asset allocation at December 31, 2004 was: Domestic Equities 51.3%, International Equities 17.5%, Fixed Income 23.3%, TIPS 6.9%, Alternative Investments .6%, Cash .2% and Real Estate .2%.

Capital Markets and Economic Conditions

During the quarter, the U.S. economy continued to add jobs, 415,000 in October and November, and unemployment remained unchanged at 5.4%. The U.S. trade deficit reached record levels as it widened to more than \$500 billion in November. High oil prices and a large trade imbalance with China were the significant contributors. Oil prices peaked in late October and then declined over the remainder of the quarter. The Federal Reserve continued its move toward a neutral monetary policy, increasing the federal funds rate by 50 basis points over the quarter to 2.25%. The U.S. dollar continued to slide, losing roughly 9% of its value against the euro. The dollar's decline was fueled by concerns over the twin trade and budget deficits as well as anxiety over foreign investment in dollar-denominated securities. Despite this deterioration in the investment environment for dollar assets, unprecedented growth of foreign buying of U.S. fixed income securities continued.

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As shown in the chart to the right, stocks ended the year with a solid rally. Every sector and most countries across the globe recorded positive returns. The strongest returns came from the emerging markets sector, up 17% for the quarter, as a result of appreciating currencies (nearly half of the quarter's gains) and credible fiscal and monetary policies.

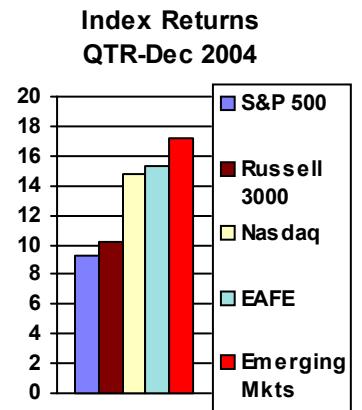
Within the domestic equity markets, small stocks outperformed large capitalization stocks for the quarter and for the year. REITs continued their strong rally, up nearly 17% for the quarter ending the year with a 34% gain. U.S. sectors with the strongest returns were information technology, utilities, and industrials. The energy sector, pharmaceuticals and insurance stocks suffered the largest losses. Our combined domestic equity performance was a gain of 10.78% for the quarter, slightly better than the 10.15% gain recorded by the Russell 3000 benchmark index.

Our combined international equity performance was a gain of 15.01% for the quarter. The weakness in the U.S. dollar increased returns substantially for U.S. investors. Europe outperformed the Pacific region during the 4th quarter but the best returns were achieved by India and Indonesia, over 24%. Among the strongest sectors of the equity markets were wireless and diversified telecommunications stocks that benefited from investors' perception that their earnings and cash flows had become more sustainable.

The Fed continued its course of gradually raising rates during the quarter, raising the discount rate twice to bring it to 2.25%. The key 10-year U.S. Treasury rate rose .10% for the quarter to 4.22%. High yield was the best performing sector for the quarter, up 4.7%, and over 10% for the year as investors were willing to take on more risk to obtain a greater return. Our combined fixed income return for the quarter was a gain of 2.42% compared to the gain of 1.74% recorded by the benchmark index. ERS investments in Treasury Inflation Protection Securities (TIPS) recorded a gain of 4.10% for the quarter, outperforming the TIPS benchmark by 100 basis points.

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2004 and fiscal year-to-date.



Employees' Retirement System Contributions and Investment Income (millions)

	Qtr <u>12/31/04</u>	Fiscal <u>YTD</u>
Employer Contributions	\$ 19.0	\$ 37.5
Member Contributions	3.9	7.8
Net Investment Income	<u>170.9</u> \$ 193.8	<u>175.9</u> \$ 221.2

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Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System

Deductions by Type

(millions)	QTR 12/31/04	Fiscal YTD
Benefits	\$ 28.8	\$ 57.1
Refunds	.1	.3
Administrative Expenses	.6	1.1
	<hr/> \$ 29.5	<hr/> \$ 58.5

Outlook

The Federal Reserve's stance, to raise interest rates gradually, may be threatened over the next few quarters as inflationary pressures continue to build. The current economic expansion continues to be characterized as consumer-led, supported by historically low interest rates, with a lack of leadership from the business sector as evidenced by slow job creation and a lack of pricing power. The continuing path toward higher, more normal interest rates is unlikely to be as smooth as during 2004.

Major Initiatives

During the quarter, the Board received the annual asset/liability study from Wilshire Associates, the investment consultant to the Board. The study recommended the Board maintain the current asset allocation strategy with the exception of exploring the addition of investments in the areas of real estate, hedge funds, commodities and other alternative investments. The Board will evaluate the return versus risk of adding these market sectors over the next few quarters.

In addition, the Board approved the fiscal year 2006 annual budget for the Employee Retirement Plans, noting that fiscal year 2004 Board-related administrative expenses were 17% below the approved budget due primarily to lower than anticipated salary costs and the re-negotiation of rent charges. Fiscal year 2005 expenses are projected to be 4% lower than the approved budget.

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

December 31, 2004

Assets

Equity in County's pooled cash and investments	\$ <u>448,270</u>
Investments	
Northern Trust	2,124,950,513
Aetna	9,767,895
Fidelity - Elected Officials Plan	<u>654,086</u>
Total investments	<u>2,135,372,494</u>
Contributions receivable	<u>5,193,795</u>
Total assets	<u>2,141,014,559</u>
Liabilities	
Benefits payable and other liabilities	<u>2,585,466</u>
Net assets held in trust for pension benefits	\$ <u>2,138,429,093</u>

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**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**
December 31, 2004

	Quarter	Fiscal YTD
Additions		
Contributions		
Employer	\$18,996,692	\$ 37,504,398
Members	<u>3,859,843</u>	<u>7,848,504</u>
Total contributions	<u>22,856,535</u>	<u>45,352,902</u>
Investment income	172,524,626	179,194,824
Less investment expenses	<u>1,576,829</u>	<u>3,271,556</u>
Net investment income	<u>170,947,797</u>	<u>175,923,268</u>
Total additions	<u>193,804,332</u>	<u>221,276,170</u>
Deductions		
Retiree benefits	26,751,699	48,526,173
Disability benefits	1,749,729	6,999,729
Survivor benefits	247,323	1,581,323
Refunds	126,498	272,091
Administrative expenses	<u>644,782</u>	<u>1,086,732</u>
Total deductions	<u>29,520,031</u>	<u>58,466,048</u>
Net increase	<u>164,284,301</u>	<u>162,810,122</u>
Net assets held in trust for pension benefits		
Beginning of period	<u>1,974,144,792</u>	<u>1,975,618,971</u>
End of period	<u>\$2,138,429,093</u>	<u>\$2,138,429,093</u>